Professional Corporations

Tax Questions Still Raised

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THE JANUARY issue of CALIFORNIA MEDICINE included an article characterized as "another chapter in a continuing saga" of professional corporations. At the time that article was prepared, the 1969 tax revision bill had just left the Senate Finance Committee, on its way to the joint House-Senate Conference Committee. Last month's article pointed out that the Senate Finance Committee had inserted a provision in the tax bill which would have limited *all* professional corporations to Keogh-type retirement plans. If that amendment had been adopted, shareholders in professional corporations would have been limited to maximum retirement plan contributions on their behalf of 10 percent of compensation or $2,500, whichever is less. Conventional corporations are able to make tax-exempt contributions of approximately 25 percent of employee compensation. The prospect that the Senate Finance Committee amendment might be included in the final version of the tax revision bill necessitated a warning to all those considering incorporation, since denial of true corporate tax-sheltered retirement programs would deny professional persons what otherwise might be a major incentive for incorporation.

The 1969 tax revision act is now law. When the bill was finally amended and adopted, the Finance Committee's provision was deleted. The Keogh-type limitation which would have been imposed on all professional corporations was not included in the law.

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Even though some professional corporations will be able to enjoy true corporate retirement plans (at least for the moment), the new law does contain one important change. Keogh-type treatment has been imposed on Subchapter "S" corporations. A Subchapter "S" corporation is one which makes a statutory election to be treated as a partnership for tax purposes. Corporate net income is taxed as if earned by the shareholders. The tax on earnings which would otherwise be paid by the corporation is therefore avoided. A Subchapter "S" corporation is limited to ten shareholders. Until now, Subchapter "S" corporations have been able to adopt qualified retirement plans, enjoying the right to make tax-exempt contributions of approximately 25 percent of compensation. This is no longer possible. The maximum contribution for Subchapter "S" shareholder-employees is now the lesser of 10 percent of compensation or $2,500. A professional corporation which wants to enjoy a true corporate retirement plan, with the larger maximum contribution, must also pay a tax on corporate earnings. The same earnings will be taxed again when distributed to the shareholders. If this income is not distributed to the shareholders, there is a risk that the IRS will characterize the corporation as a "personal holding company." The first element in the definition of a "personal holding company" is ownership of more than one-half of the stock vested in five or less persons. This test is met by any corporation with ten shareholders or less. The second element in the definition is that the corporation receive its income for personal services under circumstances where the person receiving the services has the right to designate who shall provide them. If this element is also present, a penalty tax of 70 percent on retained income may apply. It has not yet been decided whether a medical corporation might be a "personal holding company," in circumstances where patients regularly select the physicians who treat them.

The purpose of this digression into the "personal holding company" problem is to emphasize the need for competent and continuous tax counsel in this area. This is particularly true when the attitude of the Treasury Department is considered. The Treasury has announced that it will seek additional legislation restricting tax benefits available to professional corporations at the next session of Congress. Both an initial decision to incorporate and the operation of a professional corporation require sophisticated tax advice.

A December decision by the U. S. Tax Court demonstrates both the Treasury's attitude towards professional corporations and the problems physicians can encounter when requisites of tax and corporate law are ignored. A professional corporation established by four radiologists was ignored by the IRS, on the grounds that the physician-shareholders did not in fact conduct their affairs in corporate style. The Tax Court, upholding the IRS, found that each of the physicians, who had separate practices in their own names prior to incorporation, continued to practice in the same manner after incorporation, so that they did not "put flesh on the bones of the corporate skeleton." The corporation was held to be "a mere set of bookkeeping entries and bank accounts."

Some physicians, particularly those in larger groups, will find that incorporation is advantageous for non-tax reasons, such as centralized management. Some physicians, after thorough analysis of their own situation, will find tax advantages in incorporation. Any physician who does decide to incorporate must balance advantages against disadvantages and potential pitfalls, with professional advice initially and continually thereafter, unless there are radical changes in the tax system.

Attention, Psychiatrists

Charles W. Socarides, M.D., Associate Clinical Professor of Psychiatry at Albert Einstein College of Medicine, New York City, will speak at the Psychiatry and Neurology Section meeting of the Annual Scientific Assembly, March 9. Plan to attend.